Is a Pre-Petition Settlement Agreement Providing That a Debt Will Be Non-Dischargeable in Bankruptcy Enforceable?

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Commercial litigation often involves a multitude of claims, one or more of which commonly include fraud, conversion or breach of fiduciary duty. A fraud claim is generally non-dischargeable against an individual who files bankruptcy, 11 U.S.C. §523(a)(2)(A), as is a claim for “fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.” 11 U.S.C. §523(a)(4). Conversion, if determined to be “willful and malicious,” has been held to be non-dischargeable as a “willful and malicious injury to another entity or to the property of another entity.” 3 11 U.S.C. §523(a)(6). See e.g. Buke, LLCv. Eastburg (In re Eastburg), 440 B.R. 851, 860 (Bankr. D.N.M. 2010) (“the nondischargeable character of a claim for conversion requires a nondischargeability claim under 11 U.S.C. §523(a)(6)”).

Whether a debt is nondischargeable under Sections (a)(2), (a)(4) or (a)(6) must be determined upon the filing of a complaint within a specified time period. See 11 U.S.C. §523(c)(1); Fed. R. Bankr. P. 4007. Once such a proceeding is commenced, however, the determination of whether a particular debt is nondischargeable can be governed by the results of a prepetition non-bankruptcy action based on the doctrine of collateral estoppel, or issue preclusion. See Grogan v. Garner, 498 U.S. 279, 284 n. 11, 111 S.Ct. 654, 658 n. 11, 112 L. Ed.2d 755 (1991) (“[w]e now clarify that collateral estoppel principles do indeed apply in discharge exception proceedings pursuant to §523(a)”).

When, prior to judgment, federal or state non-bankruptcy litigation reaches the settlement stage and the litigation involves claims of the type that might be non-dischargeable in bankruptcy, plaintiff’s counsel will understandably be concerned that any settlement survive a later bankruptcy filed by the individual defendant. As will be seen, this is a nuanced inquiry that cannot be addressed by simply including language in the settlement agreement that the defendant’s obligations thereunder will be non-dischargeable in bankruptcy.

A recent case in point is Hebl v. Windeshausen (In re Windeshausen), 2016 BL 61615 (Bankr. W.D. Wis. Feb. 29, 2016). There, prior to bankruptcy, the plaintiff, Hebl, sued the defendant, Windeshausen, and asserted claims of misappropriation of corporate assets of a corporation in which both had an interest. During the
litigation, the parties entered into an Agreement Regarding Submission to binding arbitration, whereby they
agreed “that is their intent that the arbitrators’ award be non-dischargeable pursuant to Archer v. Warner,
538 U.S. 314 (2003).” 4 Id.

The matter proceeded to arbitration and the plaintiff, Hebl, was awarded $310,000. The award was
confirmed by the state court, but it contained no findings of fact. Id. at *1. The defendant, Windeshausen,
then filed a chapter 7 bankruptcy and Hebl sought to enforce the non-dischargeability agreement the parties
entered into pre-petition by filing a complaint for nondischargeability and a motion for summary judgment.
Id.

The bankruptcy court held that the parties' agreement to make the arbitrators' award non-dischargeable in
bankruptcy was unenforceable because it was, in effect, a pre-petition agreement to waive a discharge of that
particular debt, which courts have held are void or unenforceable “‘because [they] offend the public policy of
promoting a fresh start for individual debtors.’” Id. at *4 (quoting Lichtenstein v. Barbanel, 161 Fed. Appx.
461 (6th Cir. 2005)).

The decision in Windeshausen follows a long line of authority holding that “a state court stipulated judgment
where the debtor waives his right to discharge is unenforceable as against public policy.” Hayhoe v. Cole (In
re Cole), 226 B.R. 647, 653 (9th Cir. BAP 1998). See also Bank of China v. Huang (In re Huang), 275 F.3d
1173, 1176-77 (9th Cir. 2002) (settlement of litigation by settlement agreement which was approved by
court and provided that judgment debt was non-dischargeable in bankruptcy amounted to an unenforceable
prepetition waiver of the right to a discharge); Tamasco v. Nicholls (In re Nicholls), 2010 BL 293274 (Bankr. E.
D.N.Y. Dec. 10, 2010) (stipulated judgment under which debtors agreed that judgment would be
nondischargeable under §523 of the Bankruptcy Code considered a “prepetition waiver of discharge” that
was not enforceable as “against public policy”); Double v. Cole (In re Cole), 428 B.R. 747, 753 (Bankr. N.D.
Ohio 2009) (agreement settling litigation which acknowledged settlement debt as non-dischargeable under §
§523(a)(2), (a)(4) and (a)(6) was unenforceable); Greensward, Inc. v. Cietek (In re Cietek), 390 B.R. 773,
is against public policy” and therefore unenforceable); Marra, Gerstein & Richman v. Kroen (In re Kroen), 280
B.R. 347, 351 (Bankr. D.N.J. 2002) (observing that prepetition waivers of discharge “are void, offending the
public policy of promoting a fresh start for individual debtors”).

There are instances, however, where consent judgments providing for the non-dischargeability of the
judgment debt have been given collateral estoppel effect in later dischargeability proceedings against the
judgment debtor after a bankruptcy is filed. The case law on this subject indicates that such a result can be
achieved if the consent judgment at issue contains detailed stipulations of fact that would satisfy the
elements of non-dischargeability under §§523(a)(2), (a)(4) or (a)(6) and there is a clearly manifested intent
that the consent judgment be conclusive and binding on the issues settled in future litigation. See Klingman v.
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Levinson, 831 F.2d 1292, 1296-97 (7th Cir. 1987) (consent judgment binding on claim under §523(a)(4) where it contained detailed stipulations of fact describing dissipation of assets by a trust fiduciary and provided that the debt would not be dischargeable in any bankruptcy proceeding of the judgment debtor); Halpern v. First Georgia Bank (In re Halpern), 810 F.2d 1061, 1062, 1064-65 (11th Cir. 1987) (consent judgment binding in dischargeability proceedings under §523(a)(2) where it contained factual findings tracking the elements of fraud and an agreement that “these Findings of Fact and Conclusions of Law will collaterally estop Halpern from denying any of the facts or law established herein”); Martin v. Hauck (In re Hauck), 489 B.R. 208, 214-16 (D. Colo. 2013) (stipulated judgment which incorporated by reference specific facts in the complaint supporting plaintiff’s claims for fraud and deceit and civil theft was considered to manifest an intent to be conclusively bound and was given collateral estoppel effect on plaintiff’s claims in bankruptcy under §§523(a)(2) and (a)(4), even though agreement did not explicitly state that debt would be nondischargeable in bankruptcy), aff’d 541 Fed. Appx. 898 (10th Cir. 2013). Compare Tamasco v. Nicholls (In re Nicholls), 2010 BL 293274 (Bankr. E.D.N.Y. Dec. 10, 2010) (stipulated judgment based on settlement agreement which provided that judgment was based on plaintiff’s fourth cause of action, which was for fraud, and contained a provision that judgment debt would be nondischargeable in bankruptcy, would not be collateral estoppel on plaintiff’s claim under §523(a)(2) because there was “no statement of facts upon which the parties agreed”).

Parties settling litigation should be aware and properly take account of the ever-present potential of a bankruptcy filing by the settling defendant. In order to ensure that the defendant’s settlement obligations will survive a bankruptcy discharge, an agreement providing that the debt will be non-dischargeable is not enforceable and therefore will not work. Rather, the case law suggests that the settlement must be reduced to a stipulated judgment which contains detailed findings of fact that will serve as a basis for non-dischargeability and manifests an intent to be conclusively bound by the issues settled in any future bankruptcy or other proceeding.

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